

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMO

DATE: September 28, 1998
TO: Board of Governors
FROM: Division of Banking Supervision and Regulation
(Messrs. Biern and Small)
SUBJECT: Proposed “Know Your Customer” Regulation

ACTION REQUESTED

Approval of the attached proposed “Know Your Customer” regulation and Federal Register notice of proposed rulemaking to be issued simultaneously with a substantially identical regulation to be issued by the Office of the Comptroller of the Currency.¹

DISCUSSION

Background

For the most part, over the last several years, regulations designed to deter and prevent money laundering at, or through, banks have been promulgated by the Department of the Treasury pursuant to the authority granted to that agency under the Bank Secrecy Act.² These regulations have included the reporting of large currency transactions, the preparation and maintenance of records related to the

¹ As more fully described below, the other federal banking agencies, namely the FDIC, OTS and NCUA, have under review the proposed adoption of “Know Your Customer” rules.

² The Currency and Foreign Transaction Reporting Act (31 U.S.C. 5311 et seq.) and the accompanying regulations issued there under by the United States Department of the Treasury (31 C.F.R. 103.11 et seq.)(collectively referred to as the Bank Secrecy Act).

exchange of currency for other types of monetary instruments, such as money orders, cashier's checks or traveler's checks, and the preparation and maintenance of records related to the electronic transfer of funds. They were mainly designed for the purpose of collecting relevant information necessary to conduct criminal investigations of potential money laundering violations.

Concurrent with Treasury's rulemaking authority under the Bank Secrecy Act, the Federal Deposit Insurance Act required the bank supervisory agencies to issue rules requiring that banks put in place internal controls designed to ensure compliance with the regulations issued by Treasury under the Bank Secrecy Act.³ These rules basically require that banks provide for and document a system of internal controls to ensure ongoing compliance with the Bank Secrecy Act, to include independent testing, training of appropriate bank personnel and designation of an individual responsible for coordinating day-to-day compliance with the Bank Secrecy Act. Adequate internal controls designed to ensure compliance with the Bank Secrecy Act, along with compliance with the specific reporting and record keeping requirements of the Bank Secrecy Act, have been considered the basic tenants of a sound anti-money laundering regiment.

³ The relevant provisions of the Bank Secrecy Act and the Federal Deposit Insurance Act cover the activities of banks, thrifts, credit unions, and other financial institutions, such as bank holding companies, their nonbank subsidiaries, and the U.S. branches and agencies of foreign banks. For the purposes of this memorandum, as well as the attached proposed "Know Your Customer" rule, we refer only to "banks"; however, it should be recognized that all federally supervised domestic and foreign banking organizations are subject to the Bank Secrecy Act and the banking agencies' rules.

Board staff has long advocated that compliance with the Bank Secrecy Act, in and of itself, is not sufficient to ensure that a bank does not become involved in money laundering, or, for that matter, other types of illicit activities. Rather, Board staff has consistently maintained that a bank should take the necessary and reasonable steps to determine the true identity of its customers--that is, "know" its customers. It should also determine its customers' sources of funds; determine, understand and monitor the normal and expected transactions of its customers; and report appropriately any transactions of its customers that are determined to be unusual or suspicious consistent with already existing regulations of the Board requiring the reporting of suspicious transactions. By requiring banking organizations to determine the true identity of their customers, as well as to obtain knowledge regarding the legitimate activities of their customers, staff believes that the banking agencies can reduce the likelihood that banking organizations will become unwitting participants in illicit activities conducted or attempted by their customers. Staff also believes that such procedures are one of the most effective means by which a bank can protect itself from engaging in transactions designed to facilitate illicit activities.

Development of "Know Your Customer" Initiatives

In May 1996, after being questioned regarding "Know Your Customer" issues during Congressional testimony, Governor Kelley instructed Board staff to begin drafting a "Know Your Customer" regulation. The first step in the process was an extensive effort by Board and Reserve Bank staffs, in 1996 and 1997, to gain a

comprehensive understanding of the current “Know Your Customer” policies and procedures of banking organizations operating in the United States and abroad, including the private banking activities of large domestic and foreign banking organizations. Among the actions taken during this time period were the examinations of several private banking operations in order to determine, among other things, how they have implemented their own “Know Your Customer” policies and procedures. As a result of the year-long private banking review, a “sound practices” paper on private banking was developed and subsequently issued in July 1997.⁴ Information gathered from the private banking examinations provided staff with some basic information that was necessary before draft regulations covering banking organizations’ relationships with their customers could be prepared.

In August of last year, Board staff presented a preliminary draft regulation to the Board’s Committee on Supervisory and Regulatory Affairs seeking the Committee’s guidance on the principles that were set forth in the proposed regulation. Having obtained the Committee’s guidance, staff began discussions with the other federal bank regulators and the Financial Crimes Enforcement Network of the Department of the Treasury (“FinCEN”) in an effort to design a coordinated regulation that would address the “Know Your Customer” activities of all federally-supervised banking organizations. Representatives of the five federal bank supervisory agencies

⁴ The Federal Reserve Bank of New York conducted the study on private banking operations and prepared the “sound practices” paper, which was distributed to the domestic and foreign banking organizations supervised by the Federal Reserve and to the public through an SR Letter.

and FinCEN have been meeting over the past year in an attempt to develop a coordinated approach to “Know Your Customer” regulations.

Overview of the Proposed Regulation

The proposed regulation will require institutions supervised by the Board to develop and implement a “Know Your Customer” program. The proposal states that the creation of a “Know Your Customer” program is intended to protect the reputation of the bank; facilitate the bank’s compliance with all applicable statutes and regulations (including the Bank Secrecy Act and the Board's suspicious activity reporting regulations) and with safe and sound banking practices; and protect the bank from becoming a vehicle for or a victim of illegal activities perpetrated by its customers.

In developing the proposed regulation, Board staff recognized that banks vary considerably in the way in which they conduct their business. Therefore, rather than impose a list of specific requirements that a bank would have to meet in order to be in compliance with the proposed regulation, the proposal allows each bank to develop its own “Know Your Customer” program as a system designed to meet the delineated goals of the proposal. Specifically, and as set forth in greater detail in the attached proposed Federal Register notice, the regulation will require banks to develop a “Know Your Customer” program that, at a minimum, will provide a system for:

- a. Determining the true identities of the bank's customers;
- b. determining the customer's sources of funds for transactions involving the bank, including the types of instruments used and from where the funds were derived or generated;
- c. determining the particular customer's normal and expected transactions involving the bank;
- d. monitoring customer transactions to determine if such transactions are consistent with normal and expected transactions for that particular customer or for customers in the same or similar categories or classes, as established by the bank;
- e. identifying customer transactions that do not appear to be consistent with normal and expected transactions for that particular customer or for customers in the same or similar categories or classes, as established by the bank; and
- f. determining if a transaction is unusual or suspicious, in accordance with the Board's suspicious activity reporting regulations and reporting accordingly.

The proposal allows each bank to decide how best, consistent with its own business practices, it can identify its customers, understand the normal and expected transactions of its customers and then monitor, on an ongoing basis, the transactions of its customers. The proposal requires that, once a bank decides on a "Know Your Customer" program suited to its particular needs, it reduce the program to writing and evidence that it is following the program.

Issues of Heightened Interest

It should be understood that while a majority of the banks supervised by the Board already have instituted some form of "Know Your Customer" program, this

will be the first time that banks will be required to formalize such a program. The required “Know Your Customer” program is a “top to bottom” approach in that the proposal will require banks to understand to whom they are offering their bank’s services to at the inception of the relationship, develop an understanding of the transactions the customers will be conducting and then monitor the transactions of those customers.

The proposed regulation will require banks to identify those individuals and entities requesting the banks’ services. Some banks, specifically, those that offer private banking services, have raised concerns about identifying their customers. The issue, as we understand it, is that one of the hallmarks of private banking is the confidentiality offered to private banking customers through the use of such entities as private investment companies, trusts, private mutual funds or investment advisory accounts. In most instances, these entities are established at offshore locations, where, it is claimed, local secrecy laws prevent the release of critical information, such as the beneficial owner of the entities. The entities, rather than the beneficial owners, then open accounts at the banks in the United States.

Board staff, however, has found that, even though a bank claims that it cannot release the beneficial owner information outside of the country where the entity is located that, in fact, the beneficial owner's identity is well known to personnel in the bank in the United States. Further, on several occasions over the last two years, we have successfully encouraged banks to obtain waivers from their customers to any perceived prohibition of the release of beneficial owner information.

The proposal's requirement to identify the true beneficial owner of each account of the bank is not designed to force a bank to disclose information in violation of foreign law. Board staff firmly believes that to allow any bank to avoid identification of beneficial ownership of any account maintained in the United States defeats the primary purpose of the proposed regulation- -to ensure that each bank knows to whom it is offering its services. The regulation is not intended to provide examiners with the ability to rummage through beneficial ownership information, but rather it is intended as a means to determine what the bank knows about its customers. Obviously, the only way examiners can make such a determination is to review all of the information collected by the bank.

The recently released report by the General Accounting Office on offshore private banking activities was critical of the fact that banks in this country lacked sufficient documentation with regard to the beneficial owners of offshore

entities that maintained accounts in the United States.⁵ The GAO claims that such deficiencies impact on the way in which banks conduct their anti-money laundering compliance programs. The GAO report clearly emphasized the need for the creation and implementation of effective “Know Your Customer” regulations as a means of addressing this problem. The proposed rule covers this area by requiring that banks provide examiners with appropriate documentation concerning the identity of the beneficial owner of a U.S. domiciled account within 48 hours of an examiner’s request for such information. No such requirement presently exists.

The monitoring requirement has also raised some concerns with banks. Several banks have stated that to monitor each account of the bank on a daily basis would create a severe hardship and would be too expensive. The proposed regulation by no means suggests that every transaction of every customer must be reviewed on a daily basis. The regulation will require banks to develop and implement effective monitoring systems, commensurate with the risks presented by the types of accounts maintained at the bank and the types of transactions conducted through those accounts. Similarly, we are not suggesting that banks must expend considerable resources to purchase sophisticated computer hardware or software as a means of complying with the proposed regulations. The effectiveness of the monitoring system of a bank's “Know Your Customer” program will be based on that

⁵ See United States General Accounting Office Report to the Chairman, Subcommittee on General Oversight and Investigations, Committee on Banking and Financial Services, House of Representatives, Money Laundering - Regulatory Oversight of Offshore Private Banking Activities, June 1998.

particular bank's ability to monitor transactions consistent with the volume and types of transactions conducted at the bank.

Board staff believes that there are numerous means by which a system can be developed to carry out the ongoing monitoring of the transactions being conducted by the customers of the bank. Therefore, it would be appropriate for a bank to design a monitoring system that would correspond to the risk associated with the types of accounts maintained and the types of transactions conducted through those accounts. The design of such a monitoring system, for example, could involve the classification of accounts into various categories based on such factors as the type of account, the types of transactions conducted in the various types of accounts, the size of the account, the number and size of transactions conducted through the account, and the risk of illicit activity associated with the type of account and the transactions conducted through the account. For certain classes or categories of accounts, which may be the majority of accounts at some banks, it may be sufficient for an effective monitoring system to establish parameters for which the transactions within these accounts will normally occur. Rather than monitoring each transaction, an effective monitoring system could entail monitoring only for those transactions that exceed the established parameters for that particular class or category of accounts.⁶

⁶ For example, customers who maintain checking accounts where their weekly, bi-weekly, or monthly wages are automatically deposited can have their transactions monitored quite differently than those of a bank's private banking customer whose transactions may consist of frequent wire transfers of large sums from foreign sources.

It should be further noted that, while some banks have stated that they believe that any “Know Your Customer” regulation will be onerous and is not necessary, many in the industry have taken a contrary position. Numerous banks, as well as such industry representatives as the American Bankers Association, have stated the need to have “Know Your Customer” regulations as a means of creating standardization of the existing, but varied, ad hoc policies and rules and allowing for a level playing field among the banks.

Finally, there are some areas addressed in the proposed “Know Your Customer” rule that require additional input from the public, and, to this end, we have included some specific questions in the attached Federal Register notice. The notice asks commenters to focus on the proposed definition of “customer” to ensure, at a minimum, that the definition is not overly broad and that we have adequately covered “beneficial” ownership-related issues; asks for comment on the applicability of the proposed rule to a bank’s counter parties (e.g., should a bank have “Know Your Customer” policies applicable to its foreign exchange counter parties?); and asks for the banking industry’s views on whether the proposal creates an uneven playing field for nonbank financial institutions (e.g., broker-dealers)--a subject discussed below.

Recent Developments

On June 11, in testimony before the House Committee on Banking and Financial Services, the Federal Reserve's role in the government's anti-money laundering initiatives and efforts to develop and issue effective "Know Your Customer" regulations were discussed. With regard to "Know Your Customer," the Committee was informed that the federal bank regulators were working cooperatively towards the development of a "Know Your Customer" regulation that, hopefully, would be completed by the end of the summer.

Simultaneous to the hearing, Congressman Leach introduced the "Money Laundering Deterrence Act of 1998." Among other provisions included in the legislation was a requirement that the Secretary of the Treasury implement "Know Your Customer" regulations within 120 days of passage of the legislation. In subsequent discussions with the Congressman's staff regarding the proposed legislation, we have been informed that the primary reasons for the provision in the draft legislation regarding "Know Your Customer" is to ensure that there are legally enforceable regulations mandating that financial institutions adopt "Know Your Customer" procedures and that similar regulations are developed for the nonbank financial sector, including broker-dealers and money transmitters. Additionally, we have been informed that the staff commentary to the proposed legislation will recognize the federal bank regulators' efforts to develop an effective "Know Your Customer" regulation and encourage the continued development and implementation

of such regulations for nonbank financial institutions. In the absence of “Know Your Customer” rules for nonbank financial institutions, banks may be put at a competitive disadvantage--an issue that we are requesting comment on in the attached notice of proposed rulemaking.

Board staff, in coordination with representatives from the other federal banking agencies, will continue to work with FinCEN to assist in their efforts to promulgate effective “Know Your Customer” rules for nonbank financial institutions and we will start to coordinate with the staff of the Securities and Exchange Commission, who have expressed an interest in learning more about the banking agencies’ “Know Your Customer” rules.

Coordination With Federal Banking Agencies

As set forth above, over the last year the federal banking agencies have worked together to develop acceptable “Know Your Customer” rules. At the staff level, the agencies have come to an agreement as to the content of such rules. However, there is not universal agreement among the federal banking agencies that “Know Your Customer” standards should be promulgated by regulation. Both the staffs of the OCC and OTS concur with Board staff that it is appropriate to issue a regulation with regard to “Know Your Customer.” To this end, the OCC is currently completing its internal review of the proposed regulation and OCC staff anticipates that the regulation will be approved by the Comptroller and be ready for publication in the Federal Register

within the next two weeks. We believe that it will be beneficial to the banking community to publish the Board's and the OCC's notice of proposed rulemaking for the "Know Your Customer" regulations in the Federal Register at the same time. Therefore, we will not submit our proposal to the Federal Register until such time as the OCC has completed its approval process. The OTS is also continuing its internal review process, and it is anticipated by OTS staff that their notice of proposed rulemaking will be ready for publication in the Federal Register within the next month.

The Board of Directors of the FDIC, in the near future, will be asked to determine whether "Know Your Customer" standards should be issued as regulations or guidelines. The NCUA remains undecided, at this point in time, as to whether they will adopt a regulation or issue some form of guidance.

Delegation of Authority to Make Conforming Changes

As staff is coordinating the Board's proposed regulation with the other federal banking agencies in order to issue "Know Your Customer" standards that are as identical as possible, we request that the Board delegate to Director of the Division of Banking Supervision and Regulation, with the concurrence of the Board's General Counsel, the authority to make changes to the proposed regulation and the Federal Register notice to conform with changes that may be suggested by the other agencies after the Board's consideration of this matter this week.

Implementation of Section 8(s) of the Federal Deposit Insurance Act

Section 8(s) of the Federal Deposit Insurance Act authorizes the Board and the other federal banking agencies to prescribe regulations requiring banking organizations to establish and maintain procedures reasonably designed to assure compliance with the Bank Secrecy Act. The proposed “Know Your Customer” regulation would be issued, inter alia, pursuant to the authority granted to the Board under section 8(s) and, consistent with the statutory requirements of section 8(s), would also make the Board’s Bank Secrecy Act-related rules currently set forth in section 208.63 of the Board’s Regulation H applicable to Edge and Agreement corporations, bank holding companies and their nonbank subsidiaries, and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve through new subsections that are being added to the Board’s Regulations K and Y.

RECOMMENDATION

The Board approve the publication of the attached proposed “Know Your Customer” regulation in the Federal Register and approve the aforementioned delegation.

The Board’s Legal Division contributed to this proposal.

Attachment

D R A F T / F R B - - OCT. 1, 1998

FEDERAL RESERVE SYSTEM

12 CFR Parts 208, 211, and 225

[Regulations H, K and Y; Docket No. R-]

Membership of State Banking Institutions in the Federal Reserve System; International Banking Operations; Bank Holding Companies and Change in Control

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is requesting comments on proposed regulations requiring domestic and foreign banking organizations supervised by the Board to develop and maintain "Know Your Customer" programs. As proposed, the regulations would require each banking organization to develop a program designed to determine the true identity of its customers; determine its customers' sources of funds; determine, understand and monitor the normal and expected transactions of its customers; and report appropriately any transactions of its customers that are determined to be unusual or suspicious, in accordance with the Board's existing suspicious activity reporting regulations. By requiring banking organizations to determine the true identity of their customers, as well as to obtain knowledge regarding the legitimate activities of their customers, the proposed regulations will reduce the likelihood that banking organizations will become unwitting participants in illicit activities conducted or attempted by their customers.

D R A F T / F R B - - OCT. 1, 1998

The proposed regulations also implement the provisions of 12 U.S.C. 1818(s) by specifically requiring certain bank holding companies and their nonbank subsidiaries, Edge and Agreement corporations, and the U.S. branches and agencies and other offices of foreign banks supervised by the Board to establish and maintain procedures reasonably designed to ensure and monitor compliance with the Currency and Foreign Transaction Reporting Act (31 U.S.C. 5311 et seq.) and the accompanying regulations issued thereunder by the United States Department of the Treasury (31 CFR 103.11 et seq.)(collectively referred to as the Bank Secrecy Act).

DATES: Comments must be received by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: Comments should refer to Docket No, R-_____, and may be mailed to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th and Constitution Avenue, N.W., Washington, D.C. 20551. Comments also may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments received will be available for inspection in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.8 of the Board's rules regarding availability of information.

FOR FURTHER INFORMATION CONTACT: Richard A. Small, Assistant Director, Division of Banking Supervision and Regulation, (202) 452-5235. For users of

Telecommunications Devices for the Deaf (TDD) only contact Diane Jenkins, (202) 452-3544, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION:

Background

The integrity of the financial sector depends on the ability of banks and other financial institutions to attract and retain legitimate funds from legitimate customers. Banking organizations are able to attract and retain the business of legitimate customers because of the quality and reliability of the services being rendered and, as important, the sound and highly respected reputation of banking organizations within the financial sector. Illicit activities, such as money laundering, fraud, and other transactions designed to assist criminals in their illegal ventures, pose a serious threat to the integrity of financial institutions. When transactions at financial institutions involving illicit funds are revealed, these transactions invariably damage the reputation of the institution involved and, potentially, the entire financial sector. While it is impossible to identify every transaction at a financial institution that is potentially illegal or is being conducted to assist criminals in the movement of illegally derived funds, it is fundamental for safe and sound operations that financial institutions take every reasonable measure to identify their customers, understand the legitimate transactions to be conducted by those customers and, consequently, identify those transactions conducted by their customers that are unusual or suspicious in nature. By

identifying and, when appropriate, reporting such transactions, in accordance with existing suspicious activity reporting requirements, financial institutions are protecting their integrity and are assisting the efforts of the bank regulatory agencies and law enforcement authorities to thwart illicit activities at financial institutions.

The Board has long advocated that one of the most effective means by which a financial institution can both protect itself from engaging in transactions designed to facilitate illicit activities and ensure compliance with applicable suspicious activity reporting requirements is for the institution to have adequate "Know Your Customer" policies and procedures. In the Board's view, a financial institution should take the necessary and reasonable steps to determine the true identity of its customers, their sources of funds, and their normal and expected transactions and to identify unusual or suspicious activities. By "knowing" its customers, a banking organization is both better able to serve the legitimate needs of its customers and to fulfill its fiduciary and compliance responsibilities, including its Bank Secrecy Act and suspicious activity reporting requirements and, in connection with securities-related transactions, its obligations regarding whether specific securities are appropriate for specific customers. In fact, many financial institutions have already adopted policies and procedures that are consistent with the proposed "Know Your Customer" requirements and believe that such policies and procedures have enabled them to better serve their clientele, as well as comply with existing regulatory requirements.

The position of the Board is consistent with that of other countries throughout the world, as evidenced by the pronouncements of several international organizations.⁷ Numerous countries have adopted the idea of "Know Your Customer" and mandatory suspicious transaction reporting as the best means of protecting the financial sector from participating in the movement of illicit funds. Such "Know Your Customer" programs seek to stifle the criminal element, which tends to gravitate towards financial institutions that operate within poorly regulated and supervised jurisdictions, in its attempts to conduct transactions involving illegally derived funds.

The Board is also of the opinion that the requirement to establish a "Know Your Customer" program will empower financial institutions to obtain information from their customers regarding the identity, the types of transactions to be conducted and the source of funds, among other things. The collection of such information will further assist financial institutions in making a risk-based determination on matters including the extent of identifying information necessary and the amount of monitoring required, by allowing institutions to categorize their customers into different groups based on the types of services being requested and the magnitude and extent of the transactions being conducted. Effective "Know Your Customer" programs will evidence the intent of state member banks, bank holding companies, Edge and Agreement corporations, and the U.S. branches and agencies of foreign banks to take all

⁷ See the Basle Committee on Banking Regulations and Supervisory Practices, "Statement on the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering" (December 1988), as well as the Committee's, "Core Principles for Effective Banking Supervision" (April 1997); the 1988 United Nations Vienna Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances; the 1990 Council of Europe Convention; and the Financial Action Task Force Forty Recommendations, issued in 1989 and amended in 1996.

reasonable measures to thwart the facilitation of potential criminal activity.

Effective "Know Your Customer" programs will necessarily require that banking organizations develop "customer profiles" to understand their customers' intended relationships with the institution, and, thereafter, realistically determine when customers conduct transactions that are suspicious or potentially illegal. Banking organizations that already recognize the value of effective "Know Your Customer" programs and have implemented such programs may have found it difficult to convince customers of the need to provide certain information, especially when other financial institutions do not ask for such information. Because such programs will now be required by regulation, financial institutions will not be prejudiced or criticized for needlessly inquiring into the affairs of their customers. Moreover, legitimate customers should be more willing to provide the information requested by the financial institutions because they will be aware that a similar legal responsibility exists for all banking organizations supervised by the federal bank supervisory agencies.

The Board recognizes that a "Know Your Customer" requirement will impose additional burdens on some banking organizations. Mindful of that fact, the Board is striving to impose only those requirements that are necessary to ensure that banking organizations have in place adequate "Know Your Customer" programs. In a supplemental document to be provided at the time these regulations become final, the Board, in coordination with the other federal bank supervisory agencies, will provide detailed guidance on specific steps that banking organizations may consider taking as

they implement the regulations. The guidance is not intended to provide additional interpretive explanations of the regulations, but rather it will provide concrete examples of proven effective means to accomplish the requirements of the regulations, such as identifying customers and monitoring customer transactions. The Board believes that this approach strikes an appropriate balance that responds to requests for additional guidance in this area while preserving the flexibility for each institution to take steps appropriate for its customers.

In order to ensure the effective implementation of "Know Your Customer" programs at each of the domestic and foreign banking organizations supervised by the Board, the proposal also implements the provisions of Section 8(s)(1) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818(s)(1)). The "Know Your Customer" programs required by this proposal would be part of the Bank Secrecy Act-related procedures required to be adopted by the domestic and foreign banking organizations supervised by the Board.

Authority to Issue Regulations

The proposed regulations are authorized pursuant to the Board's statutory authority under Section 8(s)(1) of the Federal Deposit Insurance Act, as amended by Section 2596(a)(2) of the Crime Control Act of 1990 (Pub.L. 101-647), which requires, inter alia, the Board to issue regulations requiring state member banks, as well as other domestic and foreign banking organizations operating in the United States supervised by the Board, to establish and maintain internal procedures

reasonably designed to ensure and monitor compliance with the Bank Secrecy Act.

Effective "Know Your Customer" programs serve to facilitate compliance with the Bank Secrecy Act.

The regulations are also being proposed under the Board's general authority to prevent unsafe and unsound practices and to adopt regulations defining safe and sound conduct for banking organizations under its supervision, as well as under the Board's authority to prescribe specific operational and managerial standards for banks, as set forth in 12 U.S.C. 1831p-1(a)(2).

Proposal

The Board proposes to revise 12 CFR Parts 208, 211, and 225 by requiring state member banks, certain bank holding companies and their nonbank subsidiaries, U.S. branches and agencies and other offices of foreign banks, and Edge and Agreement corporations (collectively referred to as a "bank" or "banks") to develop and implement a "Know Your Customer" program within their institutions.⁸

The requirements of the "Know Your Customer" program are set out in general terms, reflecting the Board's view that a "Know Your Customer" program that is appropriate for one institution may not be appropriate for another. Under the proposed regulations, the Board would expect each banking organization to design a program that is appropriate to that organization, given its size and complexity, the

⁸ Generally, the "Know Your Customer" requirements set forth in this proposal will be applicable only to those bank holding companies and their nonbank subsidiaries that engage in business activities or transactions with the public and that are involved with the receipt or disbursement of customer funds.

nature and extent of its activities, its customer base and the levels of risk associated with its various customers and their transactions. The Board believes that this approach is preferable to a detailed regulation that imposes the same list of specific requirements on every organization regardless of its specific circumstances or situation.

The Office of the Comptroller of the Currency and the Office of Thrift Supervision are proposing to adopt substantially identical regulations covering national banks, federal branches and agencies of foreign banks and savings associations. As to state nonmember banks, insured state chartered branches of foreign banks and credit unions, the Federal Deposit Insurance Corporation and the National Credit Union Administration have this matter under advisement. The Board expects that federal regulators of non-bank financial institutions, such as broker-dealers, will propose similar rules in the near future.

The Board proposes to add a new paragraph (d) to section 208.63 of Regulation H of the Board (12 CFR 208.63). New paragraph 208.63(d) describes the requirements for a "Know Your Customer Program" at a state member bank. New section 211.____ of the Board's Regulation K and new section 225.____ of the Board's Regulation Y make all of section 208.63 of the Board's Regulation H, including the new "Know Your Customer" provisions of section 208.63(d), applicable to Edge and Agreement corporations, the U.S. branches and agencies of foreign banks (except a federal branch or federal agency or a state branch that is insured by the Federal

Deposit Insurance Corporation), a representative office of a foreign bank, and certain bank holding companies and their nonbank subsidiaries, respectively.

Section-by-Section Analysis

Section 208.63--Procedures for Monitoring Bank Secrecy Act Compliance

Paragraph (d)(1)--Purpose

The proposal makes it clear, by delineating the purposes for which a “Know Your Customer” program should be developed, that it is in each bank's own best interest to establish and implement such a program. The creation of a “Know Your Customer” program is intended to protect the reputation of the bank; facilitate the bank’s compliance with all applicable statutes and regulations (including the Bank Secrecy Act and the Board's suspicious activity reporting regulations) and with safe and sound banking practices; and protect the bank from becoming a vehicle for or a victim of illegal activities perpetrated by its customers.

Paragraph (d)(2)--Definitions

Because the text of the proposed regulations is set forth in Regulation H, the term “bank” is defined to mean a state member bank. Regulations K and Y will incorporate by reference the “Know Your Customer” provisions from Regulation H without repeating the entire text of the regulations and make them applicable to bank holding companies and their nonbank subsidiaries, foreign banks operating in the United States that are subject to the Bank Holding Company Act and their nonbank subsidiaries operating in the United States, Edge corporations,

Agreement corporations, and branches, agencies and representative offices of foreign banks in the United States, subject to Regulations K and Y. In most instances, however, banking organizations that do not engage in business transactions with the public will be excluded from the definition of bank, as set forth in paragraph (d)(2). For example, shell bank holding companies that solely own or control the shares of their subsidiary banks or thrifts and nonbank subsidiaries of bank holding companies that operate solely to service the activities of their affiliates and, in so doing, do not interact in any manner with any public customers will not be covered by this proposal.

The proposed regulations define the term "customer" as the person or entity who has an account involving the receipt or disbursement of funds at a bank and any other person or entity on behalf of whom such an account is maintained. The term encompasses direct and indirect beneficiaries of the account when the activity in the account involves the receipt or disbursement of funds. The term also encompasses a person or entity who owns or is represented by the customer. Under this definition, a "customer" would include an account holder, a beneficial owner of an account or a borrower. A "customer" could include the beneficiary of a trust, an investment fund, a pension fund or company whose assets are managed by an asset manager, a controlling shareholder of a closely held corporation or the grantor of a trust established in an off-shore jurisdiction. The term "customer" is not meant to include receipt of services from the bank for which no transaction involving the receipt or disbursement of customer funds occurs, such as a bank's provision of safe deposit boxes.

Paragraph (d)(3)--Establishment of Know Your Customer Program

This section of the proposed regulations requires that each bank supervised by the Board establish a "Know Your Customer" program within six months of the effective date of the regulations. Additionally, this section of the proposal will require that the "Know Your Customer" program be reduced to writing and approved by the board of directors of the bank, or a committee thereof, and the approval recorded in the official minutes of the board. For the U.S. offices of foreign banks, such approval may be obtained from the highest level management official in the United States.

As drafted, the proposed regulations do not differentiate between existing customers and new customers. The Board believes that the effectiveness of a banking organization's "Know Your Customer" program would be greatly reduced if all customer accounts in existence prior to the effective date of the regulations were excluded from its scope. However, the Board does not believe that it is practicable for a financial institution to conduct a large-scale information request from all its existing customers. Rather, the Board contemplates that a financial institution will be able to comply with the proposed regulation with respect to its existing customers by determining their normal and expected transactions using available account data, monitoring their transactions for potentially suspicious activities, and obtaining and documenting additional information from them in order to explain unusual transactions or when otherwise needed. However, for some customers, depending on the severity of the risk associated with such customers and their transactions, it may be necessary

to fulfill all of the requirements of these regulations as if these were new customers.

Paragraph (d)(4)--Contents of Know Your Customer Program

This section of the proposed regulations sets forth the specific requirements for the contents of the "Know Your Customer" program. The Board recognizes that banks vary considerably in the way in which they conduct their business on a day-to-day basis. Therefore, the Board believes that to impose regulations that simply require each bank to follow a pre-designed, standardized checklist will be of little or no value. The proposed regulations allow each bank to develop and delineate a system that will comprise the "Know Your Customer" program, consistent with the banking practices of the particular bank that, when followed by the bank, will effectively meet the requirements and goals of the regulations. This will allow each bank to design a "Know Your Customer" program specifically suited to its own situation that appropriately reflects the size and complexity of the bank, the types of customers it serves and the nature and extent of their activities at the bank.

Additionally, this section recognizes that each bank's "Know Your Customer" program may vary depending on the nature of the specific activity, the type of customers involved, the size of the transactions and other factors that reflect the bank's assessment of the risk presented. This section recognizes that it may be beneficial for banks to classify customers into varying risk-based categories that the banks can use in determining the amount and type of information, documentation and monitoring that is appropriate. While these proposed regulations will provide banking

organizations with substantial flexibility in devising an appropriate "Know Your Customer" program, the Board believes that all "Know Your Customer" programs should contain certain critical features, which are set forth herein.

Paragraph (d)(4)(I) of the proposed regulations also requires that the "Know Your Customer" program delineate acceptable documentation requirements and the due diligence procedures the bank will follow in meeting the requirements of the proposed regulations. The delineation of this information in the "Know Your Customer" program will ensure that the same standards are applied throughout the bank and will inform auditors and examiners of the bank's established standards for review of customer information.

Paragraph (d)(4)(ii) of the proposal sets forth the minimum requirements for an acceptable "Know Your Customer" program. The proposed regulations require that, rather than following a "checklist" approach, a bank may develop a "system" designed to meet the basic requirements of the regulations. The system approach allows each bank to design its own program, in accordance with its own business practices, that will best suit the bank. While this places some burden on the bank to develop the specifics of the "Know Your Customer" program, such an approach recognizes that each bank conducts business in accordance with its own policies, procedures, goals and objectives. The "Know Your Customer" program, in order to be the most effective, must be developed and implemented with the bank's regular and ordinary business practices in mind. The Board understands that,

potentially, there can be a variety of ways in which a "Know Your Customer" program can be established and operate. The Board's objective is to ensure that each bank's program meets the minimal requirements of the regulations and is best suited for that bank.

Paragraph (d)(4)(ii)(A) of the proposed regulations requires that the "Know Your Customer" program provide a system for determining the true identity of customers requesting the bank's services or benefitting from the bank's services. It is imperative that a bank establish, to its own satisfaction, that it is dealing with a legitimate person, whether the person is a natural person, corporation or other business entity. As important, the bank must be able to verify the identity of these persons and entities. The nature and extent of the identification process should be commensurate with the types of transactions anticipated by the customer and the risks associated with such transactions.

Sound practices require that the true identity of a prospective customer be satisfactorily established before a customer relationship with the bank is permanently established, consistent with the bank's "Know Your Customer" program. If a prospective customer refuses to provide any of the requested information, sound practices would require that the customer relationship not be established. Similarly, if additional or follow-up information is not forthcoming from an established customer, sound practices would require that consideration be given to terminating the relationship.

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The best identification documents available for verifying the identity of prospective customers are those which are the most difficult to obtain illicitly and the most difficult to counterfeit. These are the types of documents that a prospective customer should produce to the bank prior to establishing a banking relationship. No single form of identification can be guaranteed to be genuine, however, and, therefore, the identification process should be cumulative, obtaining enough information and documentation to assure the bank that it has properly identified the prospective customer.

As an example, an integral part of the identification process should be the prospective customer's address or place of business and telephone number. Verification of this information for some customers may include physical observation of the location at the address provided and return telephone calls, or "call backs," to determine the authenticity of the telephone number provided. Extra consideration may be required when it is determined that a prospective customer is situated outside of the area normally served by the bank.

The identification process for natural persons wishing to establish a customer relationship should include the review of appropriate identification documentation. Acceptable forms of documentation should include within the document a photograph and description of the individual, along with the signature of the individual. The documentation should also be easily recognizable identification issued by a government entity. While not an exhaustive list, some examples of

acceptable identification documentation would include: driver's license with photograph issued by the State in which the bank is located⁹; State identity card with photograph issued by the State in which the bank is located; and United States passport or alien registration card. Other forms of identification, while not sufficient to be used without corroboration, are satisfactory as forms of secondary identification that could be used in conjunction with the types of identification documentation described above to assist in identifying or verifying the identity of the prospective customer. Some examples, again while not an exhaustive list, would include: employer identification card; student identification card; out-of-State driver's license; credit card; and current utility bills from place of residence. At a minimum, the accepted forms of identification should be recorded and, if no legal impediment exists, duplicated and maintained in the customer's "file" at the bank.

Similarly, for prospective corporate or business customers, the customer identification process should include the review of appropriate documentation that allows for a means to verify that the corporation or other business entity does exist and does engage in the business, as stated. In establishing the identity of a corporate or business customer, the prospective customer should provide evidence of legal status, such as an incorporation document, a partnership agreement, association documents, or a business license. In some instances, it may also be necessary to obtain information on the controlling owners of the business or legal entities.

⁹ For customers that are located in a multi-state regional area, such as the Washington, D.C. metropolitan region, which encompasses parts of Maryland and Virginia, identification documents from a neighboring state would be acceptable.

Additionally, the prospective customer should provide a financial statement of the business, a description of the business to include such information as whether the business is in the wholesale or retail markets, and a description of the business's primary area of trade. It also may be appropriate to obtain information related to customers and suppliers of the prospective customer for purposes of verifying information presented by the prospective customer. At a minimum, all documentation reviewed, as well as verifications of the information contained therein, should be recorded and maintained within the customer's "file" at the bank.

Any practice of a bank that allows for the establishment of a customer relationship without face to face contact with bank personnel, such as banking by mail or Internet banking, poses difficulties in the identification of the prospective customer by use of the traditionally accepted practice of obtaining identification documentation to include photographic identification. Even though photographic identification in such circumstances will be impractical, other accepted means of identifying a customer are still viable. In such circumstances, special care should be given to verification of address and telephone number, as well as the use of commercially available data to compare such items as name with date of birth and social security number.

Introductions or referrals of prospective customers by established customers of the bank, while extremely valuable in providing background information about the prospective customer, cannot take the place of identification requirements

that should be set forth in the bank's "Know Your Customer" program. Details regarding the introduction or referral should be documented so that the information obtained can be effectively used to assist in the verification of the prospective customer.

The proposed regulations allow each bank to determine what documentation will be appropriate and acceptable in light of circumstances regarding that particular bank. If the identification process will allow for the possibility of exceptions to the established practice, for, as an example, accounts being established for senior citizens or minors, the possible exceptions should be delineated within the "Know Your Customer" program.

Heightened interest in the marketing of private banking activities by banks, as well as the heightened interest by banking customers, in the benefits derived from using private banking services has lead to a demonstrable increase in the number of private banking clients.¹⁰ As the market for private banking grows, so does the level of competition among institutions that provide private banking services. Accordingly, there is increased pressure to obtain new customers, increase the assets under management, and contribute a greater percentage to the net income of the bank.¹¹

¹⁰ For an in-depth discussion of private banking and sound practices associated with the administration of private banking activities, see the July 1997 Guidance on Sound Risk Management Practices Governing Private Banking Activities, prepared by the Federal Reserve Bank of New York and issued by the Board (hereinafter referred to as the "Sound Practices Paper"). The Sound Practices Paper was distributed, or made available, to banking organizations supervised by the Board by the Federal Reserve Banks pursuant to the Board's Division of Banking Supervision and Regulation SR Letter 97-19 (SUP). Copies of the Sound Practices Paper and SR Letter are available on the Board's public Internet web site (www.federalreserve.gov/).

¹¹ See Sound Practices Paper at page 2.

Emphasizing customer growth, without adopting appropriate procedures to understand a customer's personal and business background, source of funds and intended use of the private banking services, will certainly lead to increased reputational and legal risks.

Typically, private banking customers make use of such account vehicles as personal investment companies (PICs), trusts, personal mutual investment funds, or are clients of financial advisors. The establishment of such accounts serves the stated purposes of protecting the legitimate confidentiality and financial privacy of the customers that use such accounts. However, the need to identify properly the beneficial owners of such accounts, through an effective "Know Your Customer" program, is necessary to the continued safe and sound operation of the bank. Therefore, "Know Your Customer" procedures for identifying the beneficial owners of such accounts should be no different than the procedures for identifying other customers of the bank. Any needed confidentiality required by customers of a bank's private bank can be addressed by the development of special protections to limit access to information that would generally reveal the beneficial owners of these accounts.¹²

Equally important is the identification of beneficial owners of assets bought, sold or managed through a relationship with a bank. Such transactions often occur at the behest of intermediaries, such as asset managers, who may or may not be

¹² For a more specific discussion of suggested "Know Your Customer" procedures appropriate for private banking operations see generally Sound Practices Paper.

registered investment advisors, who deal with banks on behalf of one or more of their clients. For purposes of the proposed regulations, the “customer” of the bank in these types of situations would include the beneficiaries of the transactions and not just the intermediaries. The extent of the information regarding the customer that may be necessary to fulfill the bank’s “Know Your Customer” obligations should depend on a risk-based assessment of the customer and the transactions that will occur, such as the type, duration and size of the transactions, and should be addressed within the bank’s “Know Your Customer” program.

Ultimately, the amount of information necessary to identify adequately the beneficial owner of an account should be the result of a risk assessment of the customer and the intended transactions of the customer. The bank’s “Know Your Customer” program should provide the flexibility to group or categorize customers in a manner that allows the bank to better determine the amount of information necessary for such groups or categories. In some instances, however, it may not be necessary to determine the identity of the beneficiaries or ultimate recipients of the services being provided by the bank, because the true identity of these customers has already been satisfactorily established. For example, if the bank’s customer is a widely-held mutual fund or asset management fund whose shares are traded on a public exchange, a bank does not have to “know” all of the customer’s shareholders and certainly does not have to monitor the shareholders’ individual transactions that may occur through the bank. Similarly, in the event that a bank’s

customer is a financial institution supervised by the Board or another federal or state financial institutions supervisory agency and the bank is acting as an intermediary for the financial institution that is the bank's customer in such activities as check clearing or funds transfer processing, the bank is under no obligation to "know" the customers of the financial institution or monitor the transactions of the financial institution's customers. On the other hand, if the bank's customer is a mutual fund established in an off-shore jurisdiction that has a limited number of shareholders, the bank will be required to "know" the customers of the mutual fund.

Paragraph (d)(4)(ii)(B) of the proposed regulations requires that the "Know Your Customer" program provide a system for determining the source of funds of customers to include the types of instruments used and from where the funds or assets were derived or generated. An effective "Know Your Customer" program requires that a bank understand the nature and source of the funds being placed in the bank by the customer. While there may a tendency to view questions regarding the source of funds being placed with the bank as an infringement on a customer's privacy, failure to have such information can potentially result in severe consequences for the bank. Under standards that currently exist in criminal law, failure to obtain knowledge that is readily available, such as the source of funds of a particular customer, because of a desire to avoid the perceived embarrassment of having to obtain such information, can lead to the prosecution for a money laundering violation when it is later determined that the

funds in question were derived from illicit activity.¹³ Adoption of, and adherence to, a “Know Your Customer” program can substantially minimize the risks to a bank.

For purposes of determining and documenting the source of funds, the amount of information necessary can depend on the type of customer in question. As an example, for a majority of retail banking customers that maintain transaction accounts, where practically the only source of funds comes from payroll deposits, it is a relatively simple task to identify and document the source of funds as payroll deposits. On the other hand, a more detailed analysis, with a more extensive documentation process, would necessarily be required for high net worth customers with multiple deposits from a variety of sources. For these reasons, among others, it may be beneficial for banks to classify customers into varying categories, based on such factors as the types of accounts maintained and the types of transactions conducted and the potential risk of illicit activities associated with such accounts and transactions. Banks could then develop procedures, as part of the “Know Your Customer” programs, to obtain necessary information and documentation based on the risk assessment for the various categories or classes established by a bank.

Paragraph (d)(4)(ii)(C) of the proposed regulations requires that the “Know Your Customer” program provide a system for determining customers’ normal and expected transactions involving the bank. As with the importance associated with identifying the customers of the bank, it is equally important for the bank to understand

¹³ See 18 U.S.C. 1956 and 1957.

what types of transactions the customers will conduct. The primary objective of such a process is to enable the bank to predict with relative certainty the types of transactions in which a customer is likely to be engaged. Without an understanding of the normal and expected transactions of the customers of the bank, it is virtually impossible to determine if any particular transaction conducted by a customer is out of the ordinary for that particular customer, and is unusual or suspicious in nature.

Understanding a customer's normal and expected transactions is not a task that can be accomplished entirely at the inception of the account relationship. While it should be a simple task to obtain and record information as to a customer's expectations at the time of account opening, only after reviewing the customer's activity for a given period of time can a determination as to the customer's normal transactions be made. For this reason, effective "Know Your Customer" procedures for determining the normal and expected transactions for a bank's customers should envision an amount of time adequate to make these assessments.

The "Know Your Customer" procedures for determining normal and expected transactions should also take into consideration the type of account that is being established. As an example, a demand deposit account associated with a payroll deposit will not require an inordinate effort to determine that the customer will, most likely, use the account for ordinary living expenses and the deposit of the customer's salary. Conversely, a business account or an account maintained by a private banking customer may require a more in-depth analysis of the customer's intended use of the

account coupled with a heightened ongoing review of account activity to determine if, in fact, the customer has acted in accordance with the expectations developed at the inception of the account relationship.

Paragraph (d)(4)(ii)(D) of the proposed regulations requires that the "Know Your Customer" program provide a system for monitoring, on an ongoing basis, the transactions conducted by customers to determine if their transactions are consistent with the normal and expected transactions for particular customers or for customers in the same or similar categories or classes. Other than satisfactorily identifying a customer at the inception of the customer relationship with the bank, the ongoing monitoring of customer transactions is the most crucial component of an effective "Know Your Customer" program. It is imperative that the "Know Your Customer" program delineates appropriate procedures for the ongoing monitoring of the transactions conducted by its customers.

The Board is aware of the hardships that would be involved in monitoring every transaction of every customer on a continuing basis. The Board is by no means suggesting that every transaction of every customer must be reviewed on a daily basis. However, banks must develop and implement effective monitoring systems, commensurate with the risks presented by the types of accounts maintained at the bank and the types of transactions conducted through those accounts. Similarly, the Board is not suggesting that banks must expend considerable resources to purchase sophisticated computer hardware or software as a means of complying with

the proposed regulations. The effectiveness of the monitoring system of a bank's "Know Your Customer" program will be based on that particular bank's ability to monitor transactions consistent with the volume and types of transactions conducted at the bank.

There are numerous means by which a system can be developed to carry out the ongoing monitoring of the transactions being conducted by the customers of the bank. Therefore, it would be appropriate for a bank to design a monitoring system that would correspond to the risk associated with the types of accounts maintained and the types of transactions conducted through those accounts.

The design of such a monitoring system, for example, could involve the classification of accounts into various categories based on such factors as the type of account, the types of transactions conducted in the various types of accounts, the size of the account, the number and size of transactions conducted through the account, and the risk of illicit activity associated with the type of account and the transactions conducted through the account. For certain classes or categories of accounts, which may be the majority of accounts at some banks, it may be sufficient for an effective monitoring system to establish parameters for which the transactions within these accounts will normally occur. Rather than monitoring each transaction, an effective monitoring system could entail monitoring only for those transactions that exceed the established parameters for that particular class or category of accounts. Under the proposed regulations, a bank's determination as to how to monitor its various

accounts based on the risks associated with those accounts will be given great deference by the Board.

In many instances, monitoring is already occurring. As an example, monitoring of transactions already occurs as a means of complying with existing suspicious activity reporting regulations. Similarly, monitoring occurs for such things as large cash transactions, check kiting and attempted withdrawals from accounts with insufficient funds or from closed accounts.

For other categories or classes of accounts, it may be necessary to monitor each transaction conducted. One such example are transactions conducted by private banking customers. As a general proposition, transactions of private banking customers usually involve large sums of money. For this reason alone, it is important that a bank understands the nature of each transaction and reviews each transaction to ensure that the transaction is consistent with the normal and expected transactions for that particular customer or for customers in the same or similar categories or classes. Because one of the goals of private banking is to offer highly individualized service to private banking customers through the use of relationship managers, the burden of monitoring each transaction of private banking customers should not be significant. It is the Board's experience that relationship managers are very aware of each transaction conducted by a private banking customer and, in most instances, assist the private banking customer in conducting the transactions. Therefore, there should be

little, if any, hardship associated with reviewing each transaction to ensure that it is consistent with the normal and expected transactions for that particular customer.

Many banks already engage in sufficient account monitoring activities. These practices should be formalized in a sound "Know Your Customer" program, which will ensure that banks have identified and implemented procedures that adequately monitor a broad range of account activity while providing flexibility in defining the requisite monitoring activity in light of the risks associated with particular customers and the transactions being conducted.

Paragraphs (d)(4)(ii)(E) and (F) of the proposed regulations require that the "Know Your Customer" program provide a system for identifying transactions of customers that do not appear to be consistent with the normal and expected transactions for those particular customers or for customers in the same or similar categories or classes and determining if a transaction is unusual or suspicious and making a report, when necessary, in accordance with the Board's suspicious activity reporting regulations. These provisions of the proposed regulations are consistent with the already existing requirements contained within the Board's suspicious activity reporting requirements.

Paragraph (d)(5)--Compliance with Know Your Customer Program

Paragraph (d)(5) of the proposed regulations sets forth the requirements a bank must follow to ensure that it is in compliance with its "Know Your Customer" program. The requirements include that a bank provide for and document a

system of internal controls to ensure ongoing compliance, as well as provide for and document independent testing for compliance with the "Know Your Customer" program. Additionally, the bank must designate an individual responsible for coordinating and monitoring day-to-day compliance and provide for and document training to all appropriate personnel of the content and requirements of the "Know Your Customer" program.

Paragraph (d)(6)--Availability of Documentation

Paragraph (d)(6) of the proposed regulations requires, for all accounts domiciled in the United States, that all information and documentation necessary to comply with the regulations be made available for examination and inspection, at a location specified by a Board or Reserve Bank representative, within 48 hours of a request for the provision of such information and documentation. In instances where the information and documentation is at a location other than where the customer's account is maintained or the financial services are rendered, the bank must include, as part of its "Know Your Customer" program, specific procedures designed to ensure that the information and documentation is reviewed on an ongoing basis by appropriate bank personnel.

The Board is not aware of any laws or regulations that would prohibit the information and documentation relating to accounts domiciled in the United States that is required by the proposed regulations from being obtained and retained and from being made available for examination and inspection. The Board believes

that concerns related to nondisclosure provisions that may exist in foreign law are ill-founded and that such prohibitions to disclosure, if they exist, should not, in any event, present a bar to the disclosure of such information and documentation. The Board's experience, in instances where foreign laws have been raised as creating a prohibition to the disclosure of information that is required by the proposed regulations, is that, in fact, the information already exists within the banking organization in the United States because the information is used by the relationship manager, who resides in the United States, as well as other components of the bank, to provide banking services to the customer. Moreover, in other instances where banks have raised foreign law disclosure issues, the banks, at the Board's suggestion, have obtained from their customers waivers to any perceived prohibition to disclosure of the information and documentation. Therefore, in the opinion of the Board, there is no prohibition or insurmountable bar to the disclosure of the required information and documentation.

Comments Sought

In addition to other comments that commenters may feel are appropriate, the Board is seeking comments specific to the following:

1. Whether the proposed definition of "customer" is sufficient to include all persons who benefit from the transactions conducted at the bank, such as persons who establish off-shore shell companies or entities or otherwise conduct their business through intermediaries.

2. Whether the proposed definition of “customer” is too broad and will unnecessarily include persons that pose a minimal “Know Your Customer” risk.

3. Whether a bank’s “Know Your Customer” program should apply to a bank’s counter party relationships with respect to transactions in wholesale financial markets (e.g., sales or purchases involving foreign exchange or securities) and correspondent banking relationships or if, in such markets, a different standard than that applicable to retail relationships would be more appropriate and, if such a distinction is appropriate, how the definition of “customer” can be distinguished between transactional counter party customers, correspondents and retail customers.

4. Whether the proposed regulations will create a competitive disadvantage with respect to other financial sector entities offering similar services that may not be subject to the proposed regulations (citing, where possible, specific examples).

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (RFA) (5 U.S.C. 605(b)), the initial regulatory flexibility analysis otherwise required under section 603 of the RFA (5 U.S.C. 603) is not required if the head of the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities and the agency publishes such certification and a succinct statement explaining the reasons for such certification in the Federal Register along with its general notice of proposed rulemaking.

The Board hereby certifies that the proposal will not have a significant economic impact on a substantial number of small entities. The proposal should result in a net benefit to banks regardless of size because it establishes uniform rules relating to the identification of customers for all banking organizations supervised by the Board. Most banking organizations, from small to large, already have policies and procedures aimed at collecting, retaining and reviewing the types of information required by this proposal, and there should, thus, be little economic impact from this proposal.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget.

The collection of information requirements in this proposed regulation are found in 12 CFR 208, 211, and 225. This information is required to evidence compliance with section 8(s) of the Federal Deposit Insurance Act. The recordkeepers are for-profit financial institutions, including small businesses. Records must be retained for five years for inspection under the institution's established standards for review of customer information and pursuant to the Bank Secrecy Act.

The OMB control number for the information collection contained in the proposed rule is 7100-0212. The Board may not conduct or sponsor, and an

organization is not required to respond to, this information collection unless it displays a currently valid OMB control number.

Recordkeepers for this information collection include all state member banks, U.S. branches and agencies of foreign banks, Edge and agreement corporations supervised by the Board, and certain bank holding companies and nonbank subsidiaries of bank holding companies.¹⁴ The Federal Reserve estimates there will be 3,500 recordkeepers in the first year; in subsequent years, the recordkeepers will consist of newly-chartered institutions subject to the rule. The majority of the paperwork burden associated with the proposed rule is the one-time cost of developing a plan and implementing written policies and procedures. In the normal course of business, most institutions likely already have sufficient information about their customers in their files and would only need to organize and review such information. Because each institution would design its own program in accordance with its own business practices, the Federal Reserve estimates that the burden of the proposed rule would vary considerably and may range from ten to thirty hours.

The proposed rule is not expected to significantly increase the ongoing annual burden for the recordkeepers because most of the ongoing burden is incurred and accounted for under other existing information collections. Ongoing costs include gathering the required information about customers (to the extent that the bank does not already possess such information), monitoring customer transactions, and

¹⁴ The proposed rule will not apply to shell bank holding companies.

reporting unusual or suspicious transactions. Institutions likely perform most, if not all, of these tasks currently as part of their fraud prevention procedures, as part of their monitoring of transactions for reporting on the Department of the Treasury's Currency Transaction Reports (OMB No.1545-0183), and as part of their procedures to detect violations or suspicious activity reported on the Suspicious Activity Report. Because the records would be maintained at the subject organizations and are not provided to the Board, no issue of confidentiality under the Freedom of Information Act arises.

Comments are invited on: (a) whether the proposed collection of information is necessary for the proper performance of the Federal Reserve's functions, including whether the information has practical utility; (b) the accuracy of the Board's estimate of the burden of the proposed information collection, including the cost of compliance; (c) ways to enhance the quality, utility, and clarity of the information to be collected; and (d) ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology. Comments on the collection of information should be sent to Mary M. McLaughlin, Chief, Financial Reports Section, Division of Research and Statistics, Mail Stop 97, Board of Governors of the Federal Reserve System, Washington, DC 20551, with copies of such comments to be sent to the Office of Management and Budget, Paperwork Reduction Project (7100-0212), Washington, DC 20503.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Flood insurance, Mortgages, Reporting and record keeping requirements, Securities.

12 CFR Part 211

Exports, Federal Reserve System, Foreign banking, Holding companies, Investments, Reporting and record keeping requirements.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and record keeping requirements, Securities.

For the reasons set forth in the preamble, parts 208, 211, and 225 of chapter II of title 12 of the Code of Federal Regulations are proposed to be amended as set forth below:

PART 208-MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for 12 CFR Part 208 continues to read as follows:

Authority: 12 U.S.C. 36, 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1818, 1823(j), 1828(o), 1831o, 1831p-1, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 78l(b), 78l(g), 78l(l), 78o-4(c)(5), 78o-5, 78q, 78q-1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104b, 4106, and 4128.

2. Section 208.63 is amended by adding a new paragraph (d) to read as follows:

§ 208.63 Procedures for monitoring Bank Secrecy Act Compliance.

(d) Know your customer program--(1) Purpose. Paragraph (d) will ensure that banks establish and regularly maintain procedures designed to determine the true identity of their customers, as well as their customers' normal and expected transactions and sources of funds involving the bank. These procedures (referred to as the "Know Your Customer" program) are intended to: protect the reputation of the bank; facilitate the bank's compliance with all applicable statutes and regulations (including the Bank Secrecy Act and the suspicious activity reporting requirements of 12 CFR 208.20) and with safe and sound banking practices; and protect the bank from becoming a vehicle for or a victim of illegal activities perpetrated by its customers.

(2) Definitions. For the purposes of paragraph (d):

(i) Bank means a state member bank.

(ii) Customer means the person or entity who has an account involving the receipt or disbursement of funds with a bank and any other person or entity on behalf of whom such an account is maintained.

(3) Establishment of Know Your Customer Program. Within (six months from the effective date) each bank shall develop and provide for the continued administration of a Know Your Customer program. The Know Your Customer program

shall be reduced to writing and approved by the board of directors (or a committee thereof) with the approval recorded in the official minutes of the board.

(4) Contents of Know Your Customer Program. The Know Your Customer program, which may vary in complexity and scope depending on different categories or classes of customers established by the bank, must be designed to identify customers of the bank, including the customers' normal and expected transactions involving the bank and the sources of funds for those transactions involving the bank.

(i) The Know Your Customer program shall delineate appropriate documentation requirements and due diligence procedures established by the bank to comply with paragraph (d).

(ii) The Know Your Customer program shall, at a minimum, provide a system for:

(A) Determining the true identity of the bank's customers;

(B) Determining the customer's sources of funds for transactions involving the bank, including the types of instruments used and from where the funds were derived or generated;

(C) Determining the particular customer's normal and expected transactions involving the bank;

(D) Monitoring customer transactions to determine if such transactions are consistent with normal and expected transactions for that particular customer or for customers in the same or similar categories or classes, as established by the bank;

(E) Identifying customer transactions that do not appear to be consistent with normal and expected transactions for that particular customer or for customers in the same or similar categories or classes, as established by the bank; and

(F) Determining if a transaction is unusual or suspicious, in accordance with the Board's suspicious activity reporting regulations and reporting accordingly.

(5) Compliance with Know Your Customer Program. The bank shall comply with its Know Your Customer program. To ensure compliance, the bank shall:

(i) Provide for and document a system of internal controls to ensure ongoing compliance;

(ii) Provide for and document independent testing for compliance to be conducted by bank personnel or by an outside party;

(iii) Designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and

(iv) Provide for and document training to all appropriate personnel, on a regular basis, of the content and required procedures of the Know Your Customer program.

(6) Availability of Documentation. For all accounts domiciled in the United States, each bank must ensure that all information and documentation sufficient

to comply with the requirements of paragraph (d) are available for examination and inspection, at a location specified by a Board or Reserve Bank representative, within 48 hours of a Board or Reserve Bank representative's request for such information and documentation. In instances where the information and documentation is maintained at a location other than where the customer's account is maintained or the financial services are rendered, the bank must include, as part of its Know Your Customer program, specific procedures designed to ensure that the information and documentation is reviewed on an ongoing basis by appropriate bank personnel in order to comply with this paragraph (d).

PART 211-INTERNATIONAL BANKING OPERATIONS (REGULATION K)

1. The authority citation for 12 CFR Part 211 continues to read as follows:

Authority: 12 U.S.C. 221 et seq., 1818, 1841 et seq., 3101 et seq., 3901 et seq.; 15 U.S.C. 78o-5.

2. Section 211.____ is added to read as follows:

§ 211.____ Procedures for monitoring Bank Secrecy Act compliance. Each Edge corporation or any branch or subsidiary thereof, Agreement corporation or branch or subsidiary thereof, branch and agency of a foreign bank (except a federal branch or a federal agency or a state branch that is insured by the Federal Deposit Insurance Corporation), and representative office of a foreign bank in the United States shall [, by _____, 1999,] in accordance with the provisions of § 208.63 of the Board's Regulation H, 12 CFR 208.63, develop and provide for the continued administration of:

(a) A program reasonably designed to ensure and monitor compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103; and

(b) A "Know Your Customer" program reasonably designed to identify customers of the Edge or Agreement corporation or subsidiary thereof, or branch or agency, including customers' normal and expected transactions at or through the institution.

**PART 225-BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL
(REGULATION Y)**

1. The authority citation for 12 CFR Part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p-1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. § 225.____ is added to read as follows:

§ 225.____ Procedures for Monitoring Bank Secrecy Act Compliance. Each bank holding company and nonbank subsidiary thereof and each foreign bank that is subject to the BHC Act or any nonbank subsidiary of such foreign bank operating in the United States that as part of its regular business activities engages in transactions of any nature with the public (including maintaining deposit, lending, trading, custodial, or fiduciary relationships) shall [, by _____, 1999,] in accordance with the provisions

of § 208.63 of the Board's Regulation H, 12 CFR 208.63, develop and provide for the continued administration of:

(a) A program reasonably designed to ensure and monitor compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103; and

(b) A "Know Your Customer" program reasonably designed to identify customers of the company, subsidiary, or foreign bank including customers' normal and expected transactions at or through the institution.